

April 1974

## Income Tax--Tax Free Transfers to Controlled Corporations

Frederick L. Delp

*West Virginia University College of Law*

James P. Holland

*West Virginia University College of Law*

Follow this and additional works at: <https://researchrepository.wvu.edu/wvlr>



Part of the [Business Organizations Law Commons](#), [Securities Law Commons](#), and the [Tax Law Commons](#)

---

### Recommended Citation

Frederick L. Delp & James P. Holland, *Income Tax--Tax Free Transfers to Controlled Corporations*, 76 W. Va. L. Rev. (1974).

Available at: <https://researchrepository.wvu.edu/wvlr/vol76/iss3/16>

This Student Note is brought to you for free and open access by the WVU College of Law at The Research Repository @ WVU. It has been accepted for inclusion in West Virginia Law Review by an authorized editor of The Research Repository @ WVU. For more information, please contact [ian.harmon@mail.wvu.edu](mailto:ian.harmon@mail.wvu.edu).

## INCOME TAX—TAX FREE TRANSFERS TO CONTROLLED CORPORATIONS

### I. INTRODUCTION

Section 351 of the Internal Revenue Code of 1954 provides for the nontaxable exchange of property solely for the stock or securities of a controlled corporation.<sup>1</sup> Prior to the enactment of the Revenue Act of 1921, there was no statutory provision permitting the nonrecognition of gain or loss on the transfer of property to a controlled corporation.<sup>2</sup> Thus, exchanges of this nature were treated as giving rise to gain or loss.<sup>3</sup>

Compelling business considerations often precipitate transfers of property ownership from an individual to a corporate form. Limited liability is probably the best known and most frequently used reason for choosing to incorporate. Other characteristics making the corporate form of business enterprise attractive are its continuity of existence and transferability of ownership interests, its flexibility in creating various types of ownership interests, its relative ease in attracting outside capital, and the centralized management that necessarily accompanies corporate organization.

---

<sup>1</sup>The pertinent parts of section 351 provide:

(a) General Rule. No gain or loss shall be recognized if property is transferred to a corporation (including, in the case of transfers made on or before June 30, 1967, an investment company) by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

(b) Receipt of Property. If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under subsection (a), other property or money, then—

(1) gain (if any) to such recipient shall be recognized, but not in excess of—

(A) the amount of the money received, plus

(B) the fair market value of such other property received; and

(2) no loss to such recipient shall be recognized.

(c) Special Rule. In determining control, for purposes of this section, the fact that any corporate transferor distributes part or all of the stock which it receives in the exchange to its shareholders shall not be taken into account.

<sup>2</sup>INT. REV. CODE OF 1921, ch. 136, 42 Stat. 227.

<sup>3</sup>*Livingston v. Commissioner*, 18 B.T.A. 1184 (1930).

Recognizing and taxing gains arising from transactions involving the transfer of property to a controlled corporation would impose an undue onus on many relatively small businesses operated as sole proprietorships or partnerships. Congress recognized a need for these transfers, realizing that a transaction of this nature merely represented a change in the form of ownership rather than a gain or loss. Instead of leaving it to the ingenuity of the taxpayer to find a way around these transfers, Congress enacted section 202(c)(3) of the Internal Revenue Act of 1921. This statute was the precursor of section 351.

Section 202(c)(3) basically provided that no gain or loss would be recognized on the exchange of property for stock or securities of a controlled corporation.<sup>4</sup> Of course, this piece of legislation was a two-way street for the taxpayer. It enabled the taxpayer to transfer property to a corporation without realizing gain on the transaction while, at the same time, denying the taxpayer the beneficial tax consequences arising from any loss that might be involved in such a transaction. With only minor changes in statutory language, a provision similar to section 202(c)(3) has been included in every pertinent revenue statute enacted since the 1921 Act.

The Internal Revenue Code of 1954 redesignated this provision as section 351. It essentially provides that no gain or loss is recognized upon the transfer of property to a corporation by one or more persons solely in exchange for the stock or securities of the corporation, if immediately after the exchange the transferor or transferors are in control of the corporation.<sup>5</sup>

## II. THE CONTROL REQUIREMENT

Control is not defined in section 351, but the reader is referred to section 368(c). Section 368(c) dictates that the transferors must own at least eighty percent of all voting stock and eighty percent of all other classes of stock outstanding after the transfer.<sup>6</sup> The eighty percent requirement has been interpreted to mean that the transferors must own eighty percent of each class of stock.<sup>7</sup>

The eighty percent requirement is clear enough to raise few questions concerning its application, but the phrase "immediately

---

<sup>4</sup>INT. REV. CODE OF 1921, ch. 136, 42 Stat. 227.

<sup>5</sup>INT. REV. CODE OF 1954, § 351(a).

<sup>6</sup>*Id.* § 368(c).

<sup>7</sup>Rev. Rul. 259, 1959-2 CUM. BULL. 112.

after the exchange" has caused several problems. At first, the courts held that momentary control by the transferor after the exchange was sufficient to meet the control requirement.<sup>8</sup> Recently, the courts and the Commissioner have taken a more restrictive stance, maintaining that, if the transferor is legally committed to give up more than twenty percent of the stock, then, holding a controlling amount momentarily will not meet the control requirements of section 351.<sup>9</sup>

If the transferor decides to give away some of the stock and directs that more than twenty percent of it be issued directly to non-transferors, the courts have held that section 351 does not apply, since the transferor never held the controlling amount of stock.<sup>10</sup> Exactly the opposite result is reached by the courts, and exactly the same distribution of stock is achieved by the transferor, if he first receives the stock and then gives it to the intended donees.<sup>11</sup> The transferor can also qualify if he gives some of the property to the donee and has him transfer it to the corporation for stock.<sup>12</sup> In the former case, the transferor of the property receives all the stock, and his intention to transfer it immediately to a third party does not affect the satisfaction of the control requirement unless he is legally bound to make the transfer.<sup>13</sup> In the latter case, the recipient of the stock is himself a transferor of property, and any stock received by him will be counted in the control group.

The effects of these interpretations of the control requirement are twofold. First, the unwary transferor can fail in his attempt to qualify for section 351 treatment if he does not go through the legal formalities. Second, the alert transferor has an option if he does not want section 351 to apply in order to obtain a stepped-up basis

---

<sup>8</sup>Portland Oil Co. v. Commissioner, 109 F.2d 479 (1st Cir. 1940).

<sup>9</sup>May Broadcasting Co. v. United States, 200 F.2d 852 (8th Cir. 1953); Birggs Darby Const. Co. v. Commissioner, 119 F.2d 89 (5th Cir. 1941); Heberlein Manhattan Bldg. Co., 27 T.C. 1032 (1957); S. Klein on the Square, Inc., 14 T.C. 786 (1950), *aff'd*, 188 F.2d 127 (2d Cir. 1951); American Bantam Car Co., 11 T.C. 397 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950); Independent Oil Co., 6 T.C. 194 (1946); Rev. Rul. 522, 1970-2 CUM. BULL. 81.

<sup>10</sup>Fahs v. Florida Mach. & Foundry Co., 168 F.2d 957 (5th Cir. 1948); Mojoiner & Sons, Inc., 12 T.C. 837 (1949).

<sup>11</sup>Wilgard Realty Co. v. Commissioner, 127 F.2d 514 (2d Cir. 1942). The court held that the transferor had control, and his intention to transfer it was not important since he was not legally bound to make the transfer.

<sup>12</sup>F.W. Drybrough, 42 T.C. 1029 (1964). The court held that the recipient of the property was a transferor in his own right.

<sup>13</sup>Wilgard Realty Co. v. Commissioner, 127 F.2d 514 (2d Cir. 1942).

in the transferred property. He can avoid its application by directing the transferee to give him less than eighty percent of the stock or by legally binding himself prior to the exchange to convey more than twenty percent of the stock to a non-transferor third party.

### III. SERVICES

Under section 351(a), "stock or securities issued for services shall not be considered as issued in return for property."<sup>14</sup> Since services are not considered property, stock issued solely for services will not be counted towards the control test because the persons in control must all be transferors of property.<sup>15</sup> If the person receiving the stock for services is also a transferor of property, then all of his stock will be counted in the control test.<sup>16</sup> But, if the property transferred is a mere token designed to qualify the stock received for services, then none of the stock received will be counted.<sup>17</sup>

The problem with this facet of section 351 exchanges is whether activities that appear to be services can also qualify as property. Clearly, services directly to or for the new corporation are not treated as property.<sup>18</sup> When the services yield an equitable interest in property, the transfer of the equitable interest has been held to be a transfer of property.<sup>19</sup> Stock issued in exchange for money is an exchange for property.<sup>20</sup> The surrender of judgment

---

<sup>14</sup>INT. REV. CODE of 1954, § 351(a).

<sup>15</sup>William A. James, 53 T.C. 63 (1969); *Columbia Oil & Gas Co.*, 41 B.T.A. 38 (1940), *aff'd*, 118 F.2d 459 (5th Cir. 1941).

<sup>16</sup>Treas. Reg. § 1.351-1(a)(2) (1967).

<sup>17</sup>Treas. Reg. § 1.351-1(a)(1)(ii) (1967). *See Jacob S. Kamborian*, 56 T.C. 847 (1971).

<sup>18</sup>In *Garrett v. Campbell*, 360 F.2d 382 (5th Cir. 1966), taxpayer was an employee of the transferor, and all stock he received was held payment for services. In *United States v. Frazell*, 335 F.2d 487 (5th Cir. 1964), *rehearing denied*, 339 F.2d 885 (5th Cir. 1964), *cert. denied*, 380 U.S. 961 (1965), taxpayer drew maps of mining territory for a corporation to be formed. The amount by which the value of the stock issued to him exceeded the value of the maps contributed by him was payment for services. *Mailloux v. Commissioner*, 320 F.2d 60 (5th Cir. 1963) (stock issued for assistance in financing mining claims); *William A. James*, 53 T.C. 63 (1969) (stock issued for obtaining F.H.A. financing commitment); *Treas. Reg. § 1.351-1(a)(i)* (1967).

<sup>19</sup>*Roberts Co.*, 5 T.C. 1 (1945) (Under state law, a contingent fee claim amounted to an equitable interest in the subject matter upon successful completion of the litigation); *F.L.G. Straubel*, 29 B.T.A. 516 (1933) (Stock issued for an equitable interest in a patent was held issued for property).

<sup>20</sup>*Halliburton v. Commissioner*, 78 F.2d 265 (9th Cir. 1935); *George M. Holstein*

claims in exchange for stock is a stock-for-property transaction,<sup>21</sup> as is the issuance of stock by the new corporation for notes of the preceding business.<sup>22</sup> The unqualified transfer of a trade secret is a transfer of property.<sup>23</sup> Finally, an agreement by an inventor to assign future improvements on his invention has been held to be property and the payment of stock for the agreement to be a stock-for-property exchange.<sup>24</sup>

#### IV. STOCK OR SECURITIES

Since a transfer must be "solely in exchange for stock or securities"<sup>25</sup> in order to qualify for section 351 treatment, the question of what constitutes stock or securities becomes very important. Generally, the term stock has been considered self-explanatory. The regulations provide some aid by specifying that stock rights or warrants<sup>26</sup> are not stock,<sup>27</sup> but case law shows that under some circumstances stock options will be considered stock.<sup>28</sup> The determining factor in the decision to count the options is the likelihood of their exercise.<sup>29</sup> If they are bound to be exercised, they will be counted as stock in the control test, but if some doubt as to their exercise exists, they will not be included.<sup>30</sup> Stock subscriptions<sup>31</sup> present a similar problem. If substantial portions of stock

---

III, 23 T.C. 923 (1955); *Portland Oil Co.*, 38 B.T.A. 757 (1938); Rev. Rul. 356, 1969-1 CUM. BULL. 101.

<sup>21</sup>*Gage Bros.*, 13 T.C. 472 (1949); *Alexander E. Duncan*, 9 T.C. 468 (1947); E.S. Dillard, 20 CCH Tax Ct. Mem. 137 (1961).

<sup>22</sup>*Hartford-Empire Co. v. Commissioner*, 137 F.2d 540 (2nd Cir. 1943).

<sup>23</sup>Rev. Rul. 56, 1964-1 CUM. BULL. 133, *modifying* Rev. Rul. 17, 1955-1 CUM. BULL. 388, *as amplified* by Rev. Rul. 564, 1971-2 CUM. BULL. 179.

<sup>24</sup>*James C. Hamrick*, 43 T.C. 21 (1964).

<sup>25</sup>INT. REV. CODE OF 1954, § 351(a).

<sup>26</sup>A stock warrant is a certificate issued by a corporation conveying to the holder rights to purchase shares of its stock at a specified price. The term stock right means the privilege attaching to each outstanding share of stock to buy a fractional share or specified number of shares of new capital stock.

W. MEIGS, C. JOHNSON, T. KELLER & A. MOSICH, *INTERMEDIATE ACCOUNTING* 499 (1968) [hereinafter cited as MEIGS].

<sup>27</sup>Treas. Reg. § 1.351-1(a)(1) (1967).

<sup>28</sup>*Commissioner v. National Bellas Hess, Inc.*, 220 F.2d 415 (8th Cir. 1955).

<sup>29</sup>*Id.*

<sup>30</sup>*Barker v. United States*, 200 F.2d 223 (9th Cir. 1952); *Robert J. Harder*, 17 CCH Tax Ct. Mem. 494 (1958).

<sup>31</sup>Stock subscriptions occur when stock is sold under contract (subscription contract) calling for the purchaser (subscriber) to pay at a later date. MEIGS, *supra* note 26, at 479.

are subscribed by non-transferors, but are not yet paid for at the time of the exchange, control will be lost to the extent that the subscribers are non-transferors.<sup>32</sup>

The definition of securities is harder to determine. Bonds, because of their formality, have usually been classified as securities.<sup>33</sup> Debentures<sup>34</sup> present a slightly more difficult problem, but they, too, are usually considered securities.<sup>35</sup> The key exception arises when they are used to raise money to meet current expenses, rather than for purposes of investment in the assets of the business.<sup>36</sup> This exception is made because money invested to meet current expenses does not give the investor a continuing interest in the corporation.<sup>37</sup>

The classification of notes is determined in a similar manner, but they are more suspect than either of the two preceding categories because of the greater informality involved. Under the proper conditions, notes can qualify as securities.<sup>38</sup> The criteria applied to notes is best stated in the following excerpt from *Camp Wolters Enterprises v. Commissioner*:

The test as to whether notes are securities is not a mechanical determination of the time period of the note. Though time is an important factor, the controlling consideration is an overall evaluation of the nature of the debt, the degree of participation and continuing interest in the business, the extent of proprietary interest compared with the similarity of the note to a cash payment, the purpose of the advances, etc.<sup>39</sup>

---

<sup>32</sup>Charles Hall, 31 B.T.A. 125 (1934).

<sup>33</sup>*Commissioner v. Tyng*, 106 F.2d 55 (2d Cir. 1939) (unsecured bonds with twenty to forty year maturities); *Commissioner v. Freund*, 98 F.2d 201 (3d Cir. 1938) (bonds with one to six year maturities); *Wolf Envelope Co.*, 17 T.C. 471 (1951) (right to redeem after 10 years held not to disqualify bonds); Rev. Rul. 98, 1959-1 CUM. BULL. 76 (average term of 6½ years qualified); B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶3.04, at 16 (3d ed. 1971) [hereinafter cited as BITTKER & EUSTICE] (A security is "a piece of paper evidencing a corporate debt with mermaids and a steam locomotive at the top").

<sup>34</sup>Debentures are bonds that do not have specific assets pledged to secure payment of interest and principal. R. JOHNSON, *FINANCIAL MANAGEMENT* 504 (3d ed. 1969).

<sup>35</sup>*Commissioner v. Neustandt's Trust*, 131 F.2d 528 (2d Cir. 1942); *Alan O. Hickok*, 32 T.C. 80 (1959); *Karl B. Segall*, 38 B.T.A. 43 (1938); *E.S. Dillard*, 20 CCH Tax Ct. Mem. 137 (1961).

<sup>36</sup>*L & E Stirn, Inc. v. Commissioner*, 107 F.2d 390 (2d Cir. 1939).

<sup>37</sup>*Id.*

<sup>38</sup>*Parkland Place Co. v. United States*, 354 F.2d 916 (5th Cir. 1966); *Burnham v. Commissioner*, 86 F.2d 776 (7th Cir. 1936); *George A. Nye*, 50 T.C. 203 (1968).

<sup>39</sup>22 T.C. 737, 751 (1954).

While the above reference is to notes, the same criteria are applied to all forms of corporate debt.

Although the time test has generally given way to what is called the "continuity of interest" test, espoused in *Camp Wolters*, some generalizations based on the time factor can be made. Normally, instruments with maturities of less than five years are not considered securities.<sup>40</sup> However, when it can be established that the instrument was intended to represent an indefinite and proprietary interest in the new corporation, it will be classed as a security in spite of its short maturity.<sup>41</sup> Notes with maturities of ten years or longer have been held to be securities on a fairly consistent basis.<sup>42</sup> The status of instruments with maturities of between five and ten years cannot be generalized since no trend in either direction is apparent.

In *Pinellas Ice & Cold Storage Co. v. Commissioner*,<sup>43</sup> the United States Supreme Court first introduced the "continuity of interest" doctrine. This doctrine provides that the term of the debt is not the controlling factor in its classification. The controlling factor is whether the debt gives the transferor a continuing proprietary interest in the corporation. *LeTulle v. Scofield*<sup>44</sup> carried this doctrine a step further by holding that a transferor who received only bonds lacked the necessary proprietary interest to qualify for section 351 treatment. This decision has been harshly criticized on the grounds that the word securities in section 351 does not seem to denote a continuity of interest requirement, and the section requires the transferor to receive stock or securities, not

<sup>40</sup>*Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933); *Turner v. Commissioner*, 303 F.2d 94 (4th Cir. 1962); *Pacific Pub. Serv. Co. v. Commissioner*, 154 F.2d 713 (9th Cir. 1946); *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937 (2d Cir. 1932); *Robert W. Adams*, 58 T.C. 41 (1972); *Peter Raich*, 46 T.C. 604 (1966); *Nevill Coke & Chem. Co.*, 3 T.C. 113 (1944); *Sisto Fin. Corp.*, 47 B.T.A. 425 (1942); *Marjorie Fleming Lloyd-Smith*, 40 B.T.A. 214 (1939); *BRITTKER & EUSTICE*, *supra* note 33, at 15.

<sup>41</sup>*United States v. Mills*, 399 F.2d 944 (5th Cir. 1968). The jury found that a one year note, which had been renewed three times and which the holder expressed no interest in collecting, was "inextricably and indefinitely" involved in the venture.

<sup>42</sup>*Parkland Place Co. v. Commissioner*, 354 F.2d 916 (5th Cir. 1966); *Campbell v. Carter Foundation*, 322 F.2d 827 (5th Cir. 1963); *Burnham v. Commissioner*, 86 F.2d 776 (7th Cir. 1936); *George A. Nye*, 50 T.C. 203 (1968); *Baker Commodities, Inc.*, 48 T.C. 374 (1967). See *BRITTKER & EUSTICE*, *supra* note 33, at 15.

<sup>43</sup>287 U.S. 462 (1933).

<sup>44</sup>308 U.S. 415 (1940).



stock in addition to securities.<sup>45</sup> Both cases relied on the predecessor of the present section 351 which contained a requirement that the transferors receive stock in proportion to the property they transfer to the corporation.<sup>46</sup> Despite the exclusion of that test from the present section,<sup>47</sup> there are no indications in the legislative history or the subsequent case law that the *Pinellas-LeTulle* line has been overruled. Therefore, the Commissioner has recently taken the position that a transferor receiving only debt instruments is excluded from section 351 treatment.<sup>48</sup>

Since no one concrete test exists for defining securities, a pair of cases may serve to illustrate the difficulty courts have had with this problem. In one case, an Ohio district court found that notes which would not qualify as securities would satisfy the continuity of interest test because they were the equivalent of an equity interest.<sup>49</sup> In the other case, the Court of Appeals for the Fourth Circuit disallowed bonds because an anxious transferor had insisted that an acknowledgement of debt be issued to him while his accountant and attorney investigated what form the bond should take.<sup>50</sup> The lesson of these two cases is simple. They instruct the potential transferor and his attorney to make sure that the debt instrument received for the property transferred represents a continuing interest in the new corporation and not something which closely resembles cash.

## V. MID-STREAM TRANSFER PROBLEMS

When a going concern incorporates, questions arise concerning what should be taxed to the transferor or transferors, what should be taxed to the new corporation, and what should not be taxed at all. The application of the tax benefit rule has caused problems with his facet of section 351 transactions and undoubtedly will con-

---

<sup>45</sup>Griswold, "Securities" and "Continuity of Interest", 58 HARV. L. REV. 705 (1945).

<sup>46</sup>INT. REV. CODE of 1928, ch. 852, § 112, 45 Stat. 791 (now INT. REV. CODE of 1954, § 351).

<sup>47</sup>S. REP. No. 1622, 83d Cong., 2d Sess. 264 (1954), contains the following example: "If M and N each owning property having a value of \$100.00 transfers [sic] such property to a newly formed corporation X, and M receives all of the stock, such transaction would not be subject to tax under section 351."

<sup>48</sup>Rev. Rul. 73-472, 1973 INT. REV. BULL. No. 45, at 16.

<sup>49</sup>*Stanley, Inc. v. Schuster*, 295 F. Supp. 812 (S.D. Ohio 1969). The court said that the notes had the same effect as if the transferor had received stock.

<sup>50</sup>*Turner v. Commissioner*, 303 F.2d 94 (4th Cir. 1962). The court held the acknowledgment had the effect of a demand note.

tinue to do so in the future. "Early case law developed the principle that where a deduction in a prior year had reduced the taxpayer's taxable income, a subsequent recovery of the deducted item had to be included in income."<sup>51</sup> This principle is termed the tax benefit rule. Prior to 1970, this rule was applied to require transferors to include in income the allowance for bad debts upon the transfer of accounts receivable from a going business to a new corporation. *Nash v. United States*<sup>52</sup> ended this practice with regard to the transfer of net accounts receivable<sup>53</sup> because the transferor actually made no recovery of a prior deduction.<sup>54</sup> The rule will probably still be applied to a transfer at face value<sup>55</sup> since the reserve deducted will be recovered in the form of either stock or securities.<sup>56</sup>

The rule could also apply to cases where the cost of materials and supplies is deducted as a business expense at their purchase, if the materials and supplies are still on hand at the time of the transfer. Assuming the transferor receives stock or securities for these items, he will probably have to count their value as income in the year of the transfer.<sup>57</sup>

Another problem concerns efforts by transferors to transfer income earned for personal services to their controlled corporations. *Lucas v. Earl*<sup>58</sup> and *Helvering v. Horst*<sup>59</sup> established the rule that income for personal services could not be assigned. Subsequent case law has refused to allow a transferor to avoid his own tax liability by assigning his personal service income to a controlled corporation. If he makes such a transfer, he is taxed on the income when the corporation collects it.<sup>60</sup>

<sup>51</sup>I S. SURREY, W. WARREN, P. MCDANIEL & H. AULT, *FEDERAL INCOME TAXATION* 738 (1972).

<sup>52</sup>398 U.S. 1 (1970).

<sup>53</sup>Net accounts receivable are the accounts receivable less the allowance for bad debts.

<sup>54</sup>*Nash v. United States*, 398 U.S. 1 (1970); *Rowe III v. United States*, 428 F.2d 874 (6th Cir. 1970); *Schmidt Estate v. Commissioner*, 355 F.2d 111 (9th Cir. 1966).

<sup>55</sup>Face value means a transfer without first deducting the allowance for bad debts.

<sup>56</sup>*West Seattle Nat'l Bank v. Commissioner*, 288 F.2d 47 (9th Cir. 1961) (applied to a section 337 liquidation, but the principle remains the same).

<sup>57</sup>BITTKER & EUSTICE, *supra* note 33 ¶ 3.17, at 60.

<sup>58</sup>281 U.S. 111 (1930).

<sup>59</sup>311 U.S. 112 (1940).

<sup>60</sup>*Brown v. Commissioner*, 115 F.2d 337 (2d Cir. 1940) (assignment of fees for legal services); *Clinton Davidson*, 43 B.T.A. 576 (1941) (assignment of insurance commissions).

The transfer of uncollected service fees of a going business is not considered an assignment of income when the business itself is transferred to a new corporation.<sup>61</sup> The transfer of notes containing accrued interest or profit are not assignments of income but transfers of property,<sup>62</sup> as is an interest in a joint venture.<sup>63</sup>

In other instances, the Commissioner has used his power to compel a change in accounting to clearly reflect income<sup>64</sup> in order to prevent transferors from passing income earned prior to incorporation on to the new corporation. A contractor who uses a completed contract method of accounting<sup>65</sup> may be required to change his accounting method to a percentage of completion method<sup>66</sup> in order to include in income his pro rata share of the profit.<sup>67</sup> But the commissioner has lost in an attempt to impute the entire profit to the transferor.<sup>68</sup> The power to compel a change in accounting can also be used to demand a reallocation of expenses if it is determined that they are not distributed in such a way as to reflect a clear distribution of income.<sup>69</sup>

The key concern in this area is one of timing the flow of income and expenses so that the transferor and the transferee corporation each receive what is attributable to them. The cases indicate that attempts by the transferor to avoid taxes by assigning his income to a controlled corporation will prove futile.

## VI. ASSUMPTION OF LIABILITIES

Section 351 provides that, if "other property or money" is received in addition to stock or securities, gain shall be recognized to the extent of the amount of money received plus the fair market

---

<sup>61</sup>Thomas W. Briggs, 15 CCH Tax Ct. Mem. 440 (1956) (incorporation of a welcome wagon business).

<sup>62</sup>Arthur L. Kniffen, 39 T.C. 553 (1962) (accrued interest); *Divine v. United States*, 10 Am. Fed. Tax R.2d 5403, 62-2 U.S. Tax Cas. 9632 (W.D. Tenn. 1962) (notes containing profit).

<sup>63</sup>*Divine v. United States*, 10 Am. Fed. Tax R.2d 5403, 62-2 U.S. Tax Cas. 9632 (W.D. Tenn. 1962).

<sup>64</sup>INT. REV. CODE of 1954, §§ 446(b) & 482.

<sup>65</sup>Under this method, an accrual basis taxpayer reports income only on the completion of a contract, not when it is earned as would normally be the case. MEIGS, *supra* note 26, at 293.

<sup>66</sup>Under this method, the taxpayer reports the percentage of income he is entitled to receive as he earns it by completing the contract. *Id.*

<sup>67</sup>*Palmer v. Commissioner*, 267 F.2d 434 (9th Cir. 1959).

<sup>68</sup>*Commissioner v. Montgomery*, 144 F.2d 313 (5th Cir. 1944).

<sup>69</sup>*Rooney v. United States*, 305 F.2d 681 (9th Cir. 1962).

value of the other property received.<sup>70</sup> In many, if not most, section 351 exchanges, the transferee corporation assumes liabilities of the transferor or takes property encumbered by liabilities. For years after the enactment of section 202(c)(3) of the Revenue Act of 1921, the general view was that the assumption of liabilities or the taking of property subject to liabilities by the transferee was not the equivalent of the receipt of money or other property by the transferor and was not a taxable event.<sup>71</sup> However, in *United States v. Hendler*,<sup>72</sup> the United States Supreme Court reversed this view by holding that a gain resulting to a corporation from the assumption and payment of its indebtedness by another corporation with which it merged was not exempt from taxation under the Revenue Act of 1928.

In *Hendler*, the Borden Company and the Hendler Creamery Company, Inc., executed a merger which resulted in realized gains of more than six million dollars to the Hendler Company. Pursuant to the merger plan, Borden assumed and paid \$500,000 of the bonded indebtedness of Hendler. The court of appeals affirmed the judgment of the district court which held all Hendler gains nontaxable. However, the Supreme Court, in reversing the decision, viewed the assumption and payment of Hendler's debt by Borden as a direct payment to the Hendler Company. In substance, the Supreme Court treated the assumption and discharge of the transferor corporation's indebtedness by the transferee corporation as other property or "boot" and taxed it as income to the transferor.

As a result of this decision, Congress enacted legislation which reversed *Hendler*. This legislation, now embodied in section 357(a) of the 1954 Code, provides that the assumption of liabilities or the taking of property subject to liabilities does not constitute "boot" to the transferor.<sup>73</sup>

---

<sup>70</sup>INT. REV. CODE of 1954, § 351.

<sup>71</sup>BITTKER & EUSTICE, *supra* note 33, ¶ 3.07, at 22.

<sup>72</sup>303 U.S. 564 (1938).

<sup>73</sup>INT. REV. CODE of 1954, § 357. Section 357 provides:

- (a) General Rule. Except as provided in subsections (b) and (c), if—
  - (1) the taxpayer receives property which would be permitted to be received under section 351, 361, 371, or 374 without the recognition of gain if it were the sole consideration, and
  - (2) as part of the consideration, another party to the exchange assumes a liability of the taxpayer, or acquires from the taxpayer property subject to a liability, then such assumption or acquisition shall not be treated as money or other property, and shall not prevent the exchange from being within the provisions of section

## VII. ASSUMPTION OF LIABILITIES IN EXCESS OF ADJUSTED BASIS

Although section 357(a) permits the assumption of liabilities under a tax-free section 351 exchange, the exchange must be for a bona fide business purpose, or, conversely, must not be for a tax-avoidance purpose, and the amount of the liabilities assumed by the transferee corporation must not be in excess of the adjusted basis of the property transferred. Should the taxpayer fail to comply with section 357, the excess will be treated as a gain from the sale of an asset resulting in capital gain or ordinary income as the case may be.<sup>74</sup>

---

351, 361, 371, or 374 as the case may be.

(b) Tax Avoidance Purpose.

(1) In General. If, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition described in subsection (a)—

(A) was a purpose to avoid Federal income tax on the exchange, or

(B) if not such purpose, was not a bona fide business purpose, then such assumption or acquisition (in the total amount of the liability assumed or acquired pursuant to such exchange) shall, for purposes of section 351, 361, 371, or 374 (as the case may be), be considered as money received by the taxpayer on the exchange.

(2) Burden of Proof. In any suit or proceeding where the burden is on the taxpayer to prove such assumption or acquisition is not to be treated as money received by the taxpayer, such burden shall not be considered as sustained unless the taxpayer sustains such burden by a clear preponderance of the evidence.

(c) Liabilities in Excess of Basis.

(1) In General. In the case of an exchange—

(A) to which section 351 applies, or

(B) to which section 361 applies by reason of a plan of reorganization within the meaning of section 368(a)(1)(D), if the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

(2) Exceptions.—Paragraph (1) shall not apply to any exchange to which—

(A) subsection (b)(1) of this section applies, or

(B) sections 371 or 374 applies.

<sup>74</sup>*Id.* § 357(c)(1)(B).

This section has become a trap for the unwary cash basis taxpayer who transfers zero-basis receivables in a section 351 exchange. Although the book value of the assets transferred may well exceed the liabilities assumed by the transferee corporation, the liabilities will often exceed the adjusted basis of the assets transferred, because the adjusted basis of receivables for a cash basis taxpayer is zero,<sup>75</sup> and receivables often represent a large proportion of the taxpayer's assets.

Such was the case in *Peter Raich*.<sup>76</sup> Petitioners transferred all the assets and liabilities of their sole proprietorship to their controlled corporation in exchange for its entire capital stock and a demand note. The main asset transferred was trade accounts receivable, having a book value of \$77,361.66. The issue of whether the transfer constituted a taxable exchange under section 357(c) was raised. Both parties agreed that the transfer qualified as a section 351 exchange but disagreed with respect to the applicability of section 357(c). Particularly, they disagreed as to whether the liabilities assumed exceeded the adjusted basis of the property transferred.

The United States Tax Court held the exchange taxable to the extent the liabilities assumed exceeded the adjusted basis of the property transferred. The liabilities transferred consisted of trade accounts payable in the amount of \$37,719.78 and notes payable in the amount of \$8,273.03 for a total of \$45,992.81. The total assets transferred had a book value of \$88,613.39, but the trade accounts receivable, which had a book value of \$77,361.66, had an adjusted basis of zero, which made the total adjusted basis of the assets transferred \$11,251.73.<sup>77</sup> This meant the liabilities exceeded the adjusted basis of the property transferred by \$34,741.08. This amount was held a taxable gain. Petitioners contended that section 357(c) should not apply to the transfer because Congress did not intend the provision to apply when the book value of the assets transferred exceeded the liabilities assumed, and the transferor derived no economic benefit from the assumption. In support of their economic benefit theory, petitioners relied upon *N.F. Testor*.<sup>78</sup> In *Testor*, the transferor was economically benefited by

---

<sup>75</sup>Rev. Rul. 69-442, 1969-2 CUM. BULL. 53.

<sup>76</sup>46 T.C. 604 (1966).

<sup>77</sup>The taxpayer also had accounts receivable with a book value of \$1,833.97. Inexplicably, the court did not give these receivables an adjusted basis of zero, but let them retain their book value.

<sup>78</sup>40 T.C. 273 (1963), *aff'd*, 327 F.2d 788 (7th Cir. 1964).

the corporate assumption of his liabilities because the liabilities assumed by the corporation exceeded the book value of the assets as well as their adjusted basis. Petitioners also relied upon an example cited by both the House and Senate committee reports to illustrate the applicability of section 357(c). The example involved a situation where the transferor would have received a present financial windfall if no tax were imposed at the point of transfer.<sup>79</sup> However, the tax court held that Congress, in using that particular example, did not intend to limit the application of 357(c) to facts identical to those in the example or the *Testor* case.

In Revenue Ruling 69-442,<sup>80</sup> the Internal Revenue Service issued its position with regard to section 357(c) and the *Raich* case. The Service said it would apply section 357(c) to fact situations similar to *Raich* because the "section literally applies, and the legislative history clearly supports the application of that section under such circumstances."<sup>81</sup> However, the service did note that, had the taxpayer been on the accrual method of accounting rather than on the cash basis method, the adjusted basis of the trade accounts receivable would not have been zero.

In *Bongiovanni v. Commissioner*,<sup>82</sup> the taxpayer tried to avoid the result of the *Raich* case by adopting the accrual method of accounting. Taxpayer-appellant operated a masonry contracting business as a sole proprietorship using the cash receipts and disbursements method of accounting. On April 1, 1965, the taxpayer transferred all the assets and liabilities of the sole proprietorship to the Keystone Masonry Corporation in exchange for all the stock of the corporation plus the corporation's promissory note payable on demand. On his income tax return for 1965, taxpayer attempted to adopt the accrual method of accounting although he had operated his business on the cash basis method prior to the exchange. The tax court held that appellant's attempt to change accounting methods was unsuccessful.<sup>83</sup> If appellant had adopted the accrual method at the beginning of the accounting period and secured the consent of the Commissioner prior to computing his taxable income under the new method, and if the new method had clearly

---

<sup>79</sup>S. REP. NO. 1622, 83d Cong., 2d Sess. 270 (1954); H.R. REP. NO. 1337, 83d Cong., 2d Sess. A129 (1954).

<sup>80</sup>1969-2 CUM. BULL. 53.

<sup>81</sup>*Id.* at 54.

<sup>82</sup>470 F.2d 921 (2nd Cir. 1972).

<sup>83</sup>*Id.* at 922.

reflected income, the change to the accrual method would have been approved. However, appellant actually operated on the cash basis method during the entire accounting period and, at the end of the period, tried to adopt the accrual method for income tax purposes only. The Commissioner maintained that appellant realized a taxable gain in the amount of \$51,253 because the promissory note he had received from the corporation constituted other property or "boot" within the meaning of section 351(b). With this appellant agreed, accepting the resulting tax deficiency of \$12,080.44.

However, a further deficiency of \$5778.49 was assessed against appellant as a result of the Commissioner's interpretation of section 357(c). The tax court agreed with the Commissioner by holding that, since appellant was a cash basis taxpayer, his accounts receivable, work-in-process, raw materials, and tools and supplies had an adjusted basis of zero. With this adjustment, the liabilities assumed by the corporation exceeded the assets transferred, resulting in a gain of \$15,854. The gain was held to constitute ordinary income taxable under section 357(c). The tax court also held that appellant's accounts payable were liabilities for purposes of section 357(c).

The United States Court of Appeals for the Second Circuit reversed the decision of the tax court. The court stated that it did not believe the meaning of "liability" as used in section 357(c) was synonymous with the meaning attached to the term by the accounting profession. "Section 357(c) was meant to apply to what might be called 'tax' liabilities, *i.e.*, liens in excess of tax costs, particularly mortgages encumbering property transferred in a section 351 transaction."<sup>84</sup>

In stating its position, the court referred to the following example as an illustration of section 357(c):<sup>85</sup>

Thus, if an individual transfers, under section 351, property having a basis in his hands of \$20,000, but subject to a mortgage of \$50,000, to a corporation controlled by him, such individual will be subject to tax at rates applicable to the sale of capital assets with respect to the \$30,000, the excess of the liabilities over the adjusted basis of the property in the hands of the transferor.<sup>86</sup>

---

<sup>84</sup>*Id.* at 924.

<sup>85</sup>*Id.*

<sup>86</sup>The language of the quotation is found in S. REP. NO. 1622, 83d Cong., 2d



The court was of the opinion that, although the legislative history of section 357(c) was not very illuminating, the purpose of that section was to prevent a taxpayer from acquiring a permanently tax-free gain by mortgaging certain property for an amount in excess of the basis of the property and then transferring the property and mortgage under section 351. Feeling it was unacceptable to apply a combination of sections 351 and 357(c) to trap an individual merely because he was a cash basis taxpayer rather than an accrual basis taxpayer, the court found there was no such tax avoidance purpose in this case. Appellant was denied a deduction for his uncollected liabilities because he was on the cash basis, but those same liabilities were recognized as gain under the Commissioner's strict interpretation of section 357(c). Thus, the Bongiovannis were disadvantaged twice, if not taxed twice.<sup>87</sup> The court's holding was, therefore, based strictly on its interpretation of the meaning of the word "liability" as used in section 357(c) and as mentioned in the legislative history of the section. In the court's interpretation, the payables of a cash basis taxpayer are "liabilities" for accounting purposes but should not be construed as "liabilities" for tax purposes under section 357(c).

Since this is the only decision to date to interpret section 357(c) in this manner, it will be interesting to see which direction future cases will take. The tax court sitting in the Second Circuit will follow the decision of the United States Court of Appeals for the Second Circuit, but the tax courts sitting in other circuits will not be bound by this decision. The Commissioner will probably continue to stand on his interpretation that transactions of this nature should be taxed to the extent that the liabilities assumed exceed the adjusted basis of the assets transferred. However, the better view seems to be that of the United States Court of Appeals for the Second Circuit. In order to test this decision, the Commissioner may bring a similar case in another circuit. If, as a result of this course of action, a decision favorable to the Commissioner's viewpoint is rendered, a conflict between the circuits could develop, and the ultimate decision may rest in the United States Supreme Court. Arguably, such conflict already exists as a result of the Seventh Circuit's decision in *Testor*.<sup>88</sup>

---

Sess. 270 (1954) and H.R. REP. No. 1337, 83d Cong., 2d Sess. A129 (1954). The court referred to this example in its opinion, without quoting it directly.

<sup>87</sup>470 F.2d 921, 924 (2nd Cir. 1972).

<sup>88</sup>40 T.C. 273 (1963), *aff'd*, 327 F.2d 788 (7th Cir. 1964). In *Testor* the court held that a cash basis taxpayer who transferred all his sole proprietorship's assets and

### VIII. CONCLUSION

Although the *Bongiovanni* decision is conclusive in the Second Circuit, the Commissioner need not acquiesce, and the taxpayer must, therefore, proceed with caution. A cash basis sole proprietorship or partnership contemplating a section 351 transaction should consider, well in advance of the actual transaction, changing to the accrual method of accounting. However, a change of accounting methods may pose a special problem to the small business taxpayer because of his paucity of records, especially inventory records. A change in accounting methods may also have an adverse effect on the reflection of income; the income of the sole proprietorship or partnership very likely will be different under the accrual method of accounting. This could create an undesirable tax problem of a different nature, especially for a cash basis taxpayer who had large accounts receivable during a particular accounting period but made most of his purchases with cash. A taxpayer in this situation would, upon switching to the accrual method of accounting, realize much larger taxable income than he would have under the cash basis method. This happens because his receivables, which would not be included in his gross receipts under the cash basis method, and which constitute a large proportion of his total assets, would be included in his gross receipts under the accrual method, thereby increasing his taxable income. Although he would be permitted to deduct his liabilities under the accrual method, if these were small in relation to his receivables, his income would increase by a large amount merely because he changed accounting methods. Thus, the taxpayer must weigh all these factors in reaching the decision that will be most beneficial to him. If the taxpayer decides to change accounting methods, he must secure the consent of the Commissioner prior to computing his taxable income under the new method, and the new method must clearly reflect income. Otherwise, the Commissioner will choose a method which does clearly reflect income.<sup>89</sup> In deciding whether to change accounting methods prior to a section 351 exchange, the taxpayer should keep

---

liabilities to his controlled corporation was taxable on the excess of liabilities assumed by the corporation over the adjusted basis of the property transferred. However, in *Testor*, the liabilities assumed by the corporation exceeded not only the adjusted basis but also the book value of the property transferred. The facts in *Bongiovanni* are decidedly different in this respect since the assumed liabilities exceeded only the adjusted basis of the property transferred. Viewed in this light, *Testor* does not appear to present a true conflict between the circuits as to the applicability of section 357(c).

<sup>89</sup>INT. REV. CODE OF 1954, § 446.

in mind section 357(b), which states that the exchange must be for a bona fide business purpose and not for a tax avoidance purpose.<sup>90</sup> The taxpayer must clearly be able to justify the transaction for business-related reasons.

Possibly the simplest and most effective method of accomplishing a tax-free section 351 exchange would be for the transferor to transfer all his property except his receivables and liabilities to the transferee. If this is done, no liabilities are assumed by the transferee corporation; hence, the liabilities cannot exceed the adjusted basis of the property transferred. Or, the transferor could hold back enough of the liabilities to ensure that the adjusted basis of the property transferred exceeds the liabilities assumed. The receivables retained by the transferor would generate an inflow of cash which the transferor could use to pay off the liabilities retained.

A final alternative, which the taxpayer in *Raich* unsuccessfully attempted to use, consists of asserting that the receivables, even if not valued at market, should still offset the payables. To support this contention, the taxpayer attempted to prove that his accounts receivable were encumbered by liens, so that as soon as they were collected the proceeds would be used to liquidate the payables. The court did not reject his theory but held that he had failed to prove the receivables were actually so encumbered.<sup>91</sup> Thus, if the taxpayer can prove that his receivables are specifically encumbered by payables, this avenue may be open to him. Although the door has been unlocked by the Second Circuit, it has not been opened, and an unwary cash basis taxpayer may yet have a difficult time getting across the threshold with regard to section 351 and 357 transactions.

In addition to the problems connected with the assumption of liabilities, the taxpayer must ensure that he complies with the legal formalities relating to the control requirement. But, if the transferor wants to avoid a section 351 exchange, he can easily do so by obtaining less than eighty percent of the stock after the exchange. In order to qualify for a tax free exchange he must also avoid receiving stock predominantly in exchange for services which relate directly to the new corporation. Any debt instrument the transferor receives in exchange for his property must represent a continuing interest in the new corporation and not something

---

<sup>90</sup>*Id.* § 357(b).

<sup>91</sup>46 T.C. 604 (1966).

closely resembling cash. In order to derive the maximum benefits from a section 351 exchange, the transferor and transferee must time the flow of income and expenses so that each can receive the income attributable to him. Finally, the taxpayer must keep in mind that the exchange must be for a bona fide business purpose rather than a tax avoidance purpose. Thus, with careful planning and preparation in advance, the taxpayer can successfully incorporate his going concern, whether it is a sole proprietorship or a partnership, and avoid the payment of any taxes on the exchange.

*Frederick L. Delp*  
*James P. Holland*